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UNCLAS SECTION 01 OF 03 PANAMA 000277

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SUBJECT: PANAMA: FISCAL REFORMS PASS WITH A GRIMACE

REF: A. PANAMA 00235

[1B.](#) PANAMA 00089

SUMMARY

[¶1.](#) (SBU) In a show of political courage and discipline, and despite yelps of pain from business and white collar groups, President Torrijos and his Democratic Revolutionary Party (PRD) swiftly passed a fiscal reform package on January 31 that was signed into law February 2 (see Reftels). After two weeks of seemingly constant civil society consultations, sporadic but peaceful protests, and three required legislative debates, the sometimes reluctant PRD legislative delegation shepherded the package through the National Assembly substantially intact. According to a senior GoP official, the new law's revenue increases and public payroll cuts should generate an additional \$350 million through 2006, 80% of which will go to infrastructure (roads, housing, drinking water), education, and health care. Opposition politicians predictably blasted the bitter medicine of a tax increase but nearly everyone acknowledged the need for one. Public opinion seems cautiously optimistic that the GoP will not squander the increased revenue and will keep its promise to cut payroll spending. The GoP's performance on fiscal reform signals its determination not to flinch when it cracks the much tougher nut of social security reform. End Summary.

Key Aspects

[¶2.](#) (U) Despite some modifications, and with several defections from opposition legislators, the Torrijos administration succeeded in passing pretty much the fiscal reform package it wanted. While the actual revenue and savings effects of the fiscal reform package for 2005 are still unclear, a senior GOP official told Emboffs that reforms should generate an additional \$350 million by 2006, 80% of which will fund infrastructure (roads, housing, drinking water), education, and health care.

Spending

[¶3.](#) (U) Key features of the public spending component of the reform include:

- reducing the GOP payroll (except education, health, security) by January 2008 to the level of December 31, 1999;
- taxation of previously tax-free "representational expenses" as salary (Many public and white collar employees have received up to half their salaries as tax-free "representational expenses," basically a tax dodge that exploited an existing loophole and fenced off varying amounts of salary from the tax man and from social security levies); and
- yearly spending increases cannot exceed the percentage increase in the previous year's current revenues (starting in 2006).

Taxes

[¶4.](#) (U) On the tax side, key features include:

- an alternative minimum tax on corporations of 1.4% of gross revenues (30% of an imputed profit rate of 4.6%, which can be appealed by audit);
- increases in Colon Free Zone (CFZ) license fees, services, and a per-container levy (expected to raise \$30 million in 2005);
- an increase in registration fees for corporations;
- a selective consumption tax applied to casino and gambling activities, with a 5% rate on slot machine winnings; and
- a phasing out of certain industrial incentives.

The additional revenue generated by the alternative minimum income tax could reach as much as \$135 million according to a

senior GOP official, who noted that the current method to calculate income tax is too "deduction friendly."

Carping on Consultations

15. (SBU) Faced with the need for reform, opposition Panamenista party critics and prominent business leaders lamented the Torrijos government's lack of "consultation" to build a broad consensus. In fact, the GoP and its PRD legislative majority conducted an ambitious, two-week-long schedule of consultations that ended with an almost endless stream of ten-minute speakers before the legislature.

16. (SBU) Shortly before the law passed, Torrijos met with members of the National Council for Private Enterprise (CoNEP), an umbrella business organization, which opposed the alternative minimum tax. Holding firm, Torrijos reportedly said that he was "elected to make decisions." The GoP further stated that it would adjust reforms quickly if they proved ineffective. Some business and labor interests in Panama City and the provinces continued to demonstrate peacefully against the reforms and the Torrijos government's limited consultations.

Money Down the Drain...

17. (SBU) Nearly all non-PRD politicians were highly skeptical about how the GoP would spend its new revenues. While most business leaders conceded the need for infrastructure improvements, they questioned the GoP's ability to curb corruption and spend new revenues wisely.

or Class Warfare?

18. (SBU) Former Democratic Change (CD) presidential candidate and supermarket magnate Ricardo Martinelli portrayed the reforms as a cynical attempt to divide rich and poor, circulating an email about GoP plans to provide a \$100 subsidy to poor Panamanians. (Panamenista politician Juan Carlos Varela also took this line, even disingenuously comparing Torrijos with Venezuela's Hugo Chavez.) To Martinelli's consternation, all three CD legislators voted for the reforms. (Note: CD legislator Dalia Bernal is the sister of Torrijos's Education Minister. End Note.)

A Middle Class Tax...

19. (SBU) Panama's highly leveraged, smallish middle class found itself in the crosshairs of the reform, which will tax it more heavily by eliminating the tax-free status of "representational" expenses. One CONEP leader claimed that the reforms were a "grave error" because they would reduce the income of professionals by up to 10%. Former MOLIRENA legislator, lawyer Jorge Alberto Rosas, said the legal community predicts the reforms will prompt company mergers to reduce costs, causing layoffs of middle-class technical and professional employees.

or a Failed Canal Referendum?

110. (SBU) Opposition and PRD supporters agree that the GoP took a great risk by tackling fiscal reform and many predict it will pay a political price, possibly in a failed referendum for Canal expansion (expected in late 2005).

Comment

111. (SBU) Reactions to the fiscal reform package have been predictable, with opposition pols trying to score points, weaken the Torrijos government, and deflect attention from their own internal problems. Similarly, the business community, with a few enlightened exceptions, attempted to paint a specter of lower growth and higher consumer prices.

112. (SBU) Nonetheless, in pushing through fiscal reform with an intact alternative minimum tax, Torrijos succeeded in holding the party line in the first of the three great challenges that his administration has set itself, which also include social security reform and Canal modernization. Although some critics say that Torrijos should have pushed Canal expansion first, Torrijos perhaps wisely chose to create momentum with the easiest of his ambitious projects (not to mention that the Canal proposals are not yet in final form). Also, by passing a new law that takes action against "the rich," Torrijos puts himself in a better light with Panamanians of more modest means as he gears up to put social security on a more secure footing.